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Poland: The Persistent Debt Dilemma

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An Intelligence Assessment

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EUR 84-10188
September 1984
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Poland: The Persistent Debt Dilemma [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] with contributions by [redacted] Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, East-West Regional Branch, EURA, [redacted]

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Poland: The Persistent Debt Dilemma [redacted] 25X1

Key Judgments

Information available as of 17 September 1984 was used in this report.

Poland's financial crisis has become a trap from which neither Warsaw nor its creditors are likely to escape for many years. Poland faces a long period of austerity, and the regime continually will have to make tough decisions on the allocation of scarce hard currency, the degree of austerity the populace will accept, and the concessions it will have to make to obtain financial help from the West. Western banks and governments face the problem of sharing Warsaw's limited payment capacity and dealing with Polish demands for extremely generous debt relief and new credits. [redacted] 25X1

Although the danger of default has receded, Warsaw has made little real financial progress since it first requested debt rescheduling in March 1981:
- The Poles are in the third year of a moratorium on payments to Western governments during which arrears have risen to $11 billion, while banks have continued to provide debt relief.
- Financing sources are dwindling as new credits dry up.
- Warsaw cannot cover even the interest on its debt, and interest arrears now amount to $2.5 billion.
- The most positive development is that Poland is now running trade surpluses, which, however, have been achieved mainly by slashing imports rather than by boosting exports. [redacted] 25X1

Poland's moratorium on payments to Western government creditors has allowed Warsaw to use its scarce hard currency to support economic growth. Although data on total debt service due indicate that it represents a crushing burden on the economy, the regime has managed to minimize the share of hard currency that it devotes to debt payments. Although imports are down, Poland has continued to give greater priority to imports than to repaying debts owed to governments in order to halt the slide in national income and to supply enough consumer goods to maintain political tranquillity. At least in the short run, this is inconsistent with addressing Poland's financial problems and restoring long-term creditworthiness. [redacted] 25X1

Warsaw seems certain to fall far short of covering its 1984 financial requirement of $17 billion. Although a new agreement with Western banks completes the rescheduling of nearly all of Poland's debt to them, Warsaw still needs to come to terms with Western governments on rescheduling debt that came due in 1982-84 in order to eliminate the mountain of arrears. Poland's limited payment capacity and stronger commitment to paying banks and other creditors means that there is little room for substantial payments this year to Western governments. [redacted] 25X1

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We expect that debt service obligations will swamp Poland's payment capacity for several more years:

- Warsaw is unlikely to cover repayments of already rescheduled debt that begin next year, raising the prospect that creditors will have to renegotiate these agreements.
- Poland must record increases in exports of 15 to 20 percent annually to stem the growth of its debt in this decade. The country's limited ability to produce for export, as well as slack Western demand, will probably preclude these gains.
- Warsaw's poor credit rating and the problem of burden sharing among creditors will block the extension of new loans—the only alternative to large trade surpluses for boosting Poland's debt servicing capacity.

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Insolvency leaves the regime with few options, none of which is attractive. Internal debates about debt policy are likely to continue, slowing negotiations with creditors and blocking bold policy measures:

- Poland could maintain its relatively low priority on debt servicing in favor of imports. This policy, however, would block any return to creditworthiness and increase the eventual costs of dealing with the debt problem.

- The regime could tackle the debt problem head-on by imposing greater austerity, but the regime fears that the resulting drop in living standards would risk political and social unrest.

- A third option would be a rapprochement with the West, involving a generous rescheduling package from the Paris Club, IMF membership, and new credits. This is not likely, given continuing Western concerns about the Polish political and economic situation and likely Soviet objections to such cooperation. 25X1

In the context of these options, Warsaw's financial strategy has been to adjust gradually, running a trade surplus large enough to meet creditors' minimum demands but tempering austerity to avoid popular unrest. We expect this policy to continue, with perhaps slowly growing trade surpluses. While this strategy prevents default and domestic instability in the short run, it almost guarantees economic stagnation, no gains in living standards, and no escape from the debt trap. 25X1

[redacted] 25X1

Warsaw clings to this strategy in the hope that the West will provide a large financial package without strings attached. The regime is probably overly optimistic about the West's largess, and it underestimates the political and economic conditions the West would attach to such a package. Until Poland accepts that it must take the first steps—short-term austerity, fundamental economic reform, and sound economic policies—little real progress is possible. Thus, for perhaps many more years, the regime will be unable to gain popular support by offering a brighter economic future. Moreover, Warsaw will find it difficult to mend relations with the West as long as it neglects its financial obligations. [redacted] 25X1

The pivotal role of Western governments means that political factors will continue to play a major role in Warsaw's financial prospects. The wariness with which the Paris Club has approached rescheduling suggests that repairing the damage of martial law will be slow. Resumption of Polish payments is likely to be the governments' chief motivation in dealing with Warsaw, but the Paris Club creditors will have to break the Poles' habit of paying the banks first. [redacted] 25X1

The Poles, Allied governments, and bank creditors will watch closely Washington's policy toward Poland. To a large degree, the United States holds the key to Western policy on sanctions, debt relief, and new credits, but dividends from taking the lead are uncertain at best. Poland's bankruptcy and poor prospects mean that positive steps may well involve throwing good money after bad with no guarantee of a positive political response from Warsaw, while negative steps—keeping or toughening sanctions—may lead to an open break with the Allies, ruin prospects for improvement in relations with Warsaw, and encourage hardliners in Poland who advocate a moratorium. [redacted] 25X1

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Poland: The Persistent Debt Dilemma

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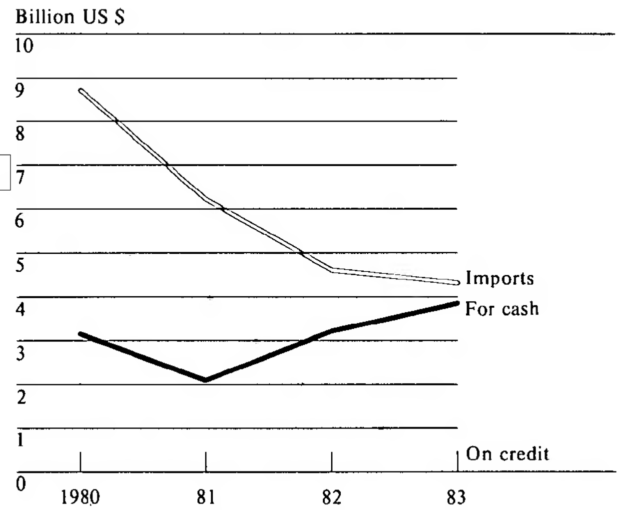
Introduction

This paper provides a status report on Poland's financial situation and assesses prospects for a resolution of its debt crisis. It surveys Warsaw's lack of progress in coping with its debt crisis since 1981 and provides a detailed look at payments performance in 1984. It also analyzes financing requirements, resources, and policy options for the rest of the decade and considers their implications for Poland's Western creditors. 25X1

Coping With Bankruptcy, 1981-83

Since March 1981, when Poland approached Western bank and government creditors to reschedule its $25 billion debt, Warsaw has been in a state of nearly constant financial crisis. Debt relief and new credits covered most of the financing requirement in 1981 but fell far short in 1982 and 1983. Creditors have pressed for payments and threatened default. Rescheduling negotiations with Western banks have been arduous while government creditors refused to grant new credits or to negotiate debt relief after martial law was imposed in December 1981. 25X1

Figure 1
Poland: Imports for Cash and Credit, 1980-83



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After enjoying substantial inflows of credit during the 1970s, Poland under martial law suddenly had to rely on its own financial resources. In 1981, credits covered 66 percent of Poland's hard currency imports; by 1983, they covered only 11 percent (figure 1). Warsaw's hard currency was stretched thin to try to cover creditors' demands for payments and to meet the most crucial needs of Poland's weakened, import-dependent economy. In order to adjust to the financial squeeze, the regime slashed imports by half from 1980 to 1983. Despite the critical need to earn hard currency, exports fell by one-third during the same period (figure 2).

Last year Warsaw could point to a few signs that it had passed the worst of the crisis. Steady improvement in the trade account continued as Warsaw earned a trade surplus of $1.1 billion. Moreover, the gap between the value of net exports and the receipts gained from net exports narrowed substantially (see inset). After a shaky start, the Poles negotiated debt relief from Western banks on better terms than in 1982 and managed for the first time in three years to cover all interest payments to banks in the same year they were due. Finally, Western government creditors relaxed their ban against debt relief talks.

These gains, however, were small compared with the 25X1 magnitude of Poland's financial problems. Warsaw failed to negotiate further debt relief with the Paris Club, and arrears—mostly to Western governments—climbed to $10 billion. In effect, the moratorium on more than half of Warsaw's debt enabled it to pay its bank creditors. Credit availability continued to decline. The substantial trade surplus was made possible only by further import cuts. 25X1

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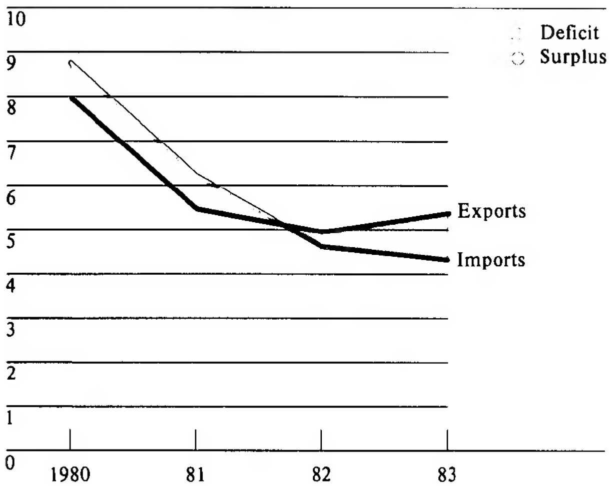
Figure 2
Poland: Hard Currency Trade, 1980-83



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The decline in Warsaw's payment capacity is a key indicator of its lack of progress in stabilizing the level of its debt (see inset). Payment capacity in 1982 and 1983 was only about half the 1981 level of $5 billion (table 1), and far short of covering financial requirements totaling more than $10 billion. The only bright spot was that a greater share of Warsaw's payment capacity was earned through a growing trade surplus rather than borrowed.

Financial Strategy: Limited and Gradual Adjustment [1]

Faced with insurmountable financing requirements—debt service obligations have been more than double hard currency earnings—the regime has pursued a course of limited adjustment by running a trade surplus large enough to meet creditors' minimum demands but not so great as to strain Warsaw's beleaguered economy.

Discrepancies in Polish Trade Data

A puzzle in Polish foreign trade data has been the wide discrepancy between the trade flows presented on a customs basis and on a payments basis. For example, Poland recorded a trade surplus with the West in 1982 of $1.47 billion but was able to convert only $358 million of the surplus into hard currency payment capacity. Last year, Warsaw explained that most of the discrepancy resulted from the inability to collect payments for exports and the need to satisfy supplier demands for payment in advance. The Poles say that export receipts in 1982 were $743 million less than the value of shipments because:
- *$192 million in export bills were overdue at the end of the year.*
- *$93 million in exports delivered in 1982 were paid for in 1981.*
- *$47 million in medium- and long-term credits were extended to finance exports.*
- *$411 million represented soft currency exports for construction projects, probably in LDCs.* 25X1

Payments for imports exceeded the value of deliveries to Poland in 1982 by $367 million, mainly because payments were made in 1982 for goods that were not received by the end of the year. 25X1

The goods-payment gap should be reversed in Poland's favor when payments catch up with deliveries for both exports and imports. The Poles told government creditors last October that in the first six months of 1983, the gap narrowed to $237 million—still against Warsaw. Only about $100 million of this represented a payments lag, with the remainder accounted for by soft currency exports. The surplus for all of 1983 on a customs basis was still about $400 million greater than on a payments basis. 25X1

Although Poland ran a record trade surplus in 1983, the economy still managed to grow for the first time in the 1980s and to increase supplies to the consumer. Warsaw's priorities have been to halt the slide in national income and to supply enough consumer goods to maintain tranquillity. These goals—at least in the short run—are inconsistent with the adjustment needed to address Poland's financial problems. 25X1

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The Concept of Payment Capacity

This paper relies heavily on the concept of payment capacity as a tool of financial analysis. Payment capacity is the amount of debt service a creditor can pay. This contrasts with import capacity—a term frequently used to estimate how much a country can import after it pays creditors. Payment capacity—another term for sources of financing other than debt relief—can be disaggregated into payment capacity that is either earned *or* borrowed. *Earned payment capacity is the amount the debtor can pay through earning a surplus from trade and other current account transactions excluding interest. Borrowed payment capacity is supplied by creditors through new loans.*

The inclusion of credits in payment capacity assumes that the debtor can take advantage of the fungibility of credits to increase debt service payments. For example, trade credits can be used to finance imports that otherwise would have been cash transactions, and the cash saved can be allocated to pay creditors. Poland's bankruptcy has reversed the priority of payments: Warsaw first sets the amount of imports it will buy and then adjusts its payments to creditors according to how much financing it obtains. Financial scenarios prepared by the Poles, for example, usually show little variation in the trade account regardless of credits available. On the other hand, changes in credit drawings translate into altered payment capacity.

Table 1
Poland:
Hard Currency Payment Capacity

Million US $

	1981	1982	1983
Total	**4,723**	**2,511**	**2,487**
Earned [a]	213	846	1,653
Trade	−751	358	1,085
Exports	5,482	4,974	5,402
Imports	6,233	4,616	4,317
Services and transfers, net (excluding interest)	795	402	407
Interest earnings	169	86	161
Borrowed	4,510	1,665	834
New credits	4,930	1,474	565
Recycled interest, net	0	196	338
Credits extended, net	−420	−5	−69

[a] Earned payment capacity equals the current account balance excluding interest payments.

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One of Warsaw's dubious achievements during the financial crisis has been to implement its own adjustment plan with little influence or interference from creditors. Poland's plans for the rest of the 1980s call for a payment capacity that we believe will be inadequate to repay debt service and for an increase in debt that creditors will be unwilling to finance. Poland's autonomy in setting its financial policy has not only given Warsaw discretion in paying a large share of its debt obligations but also has provided it some flexibility in allocating financial resources between paying for imports and paying off creditors. Although debt service is generally believed—in Poland as well as in the West—to be a crushing burden on the economy, the debt service ratio calculated on the basis of payments actually *made* was only about 35 percent in 1983, while the ratio based on payments *due* was more than 200 percent. The moratorium on payments to Western governments has meant that Poland has attempted to service only part of its debt. Warsaw has tried to justify the moratorium as a response to sanctions, but, even if the governments had negotiated debt relief, it seems likely that limited payment capacity, the regime's priorities, and the lack of creditors' leverage would have combined to keep payments at a low level. 25X1

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The Jaruzelski regime seized upon the deterioration of relations with the West after martial law as a scapegoat for failure to address the debt issue. By greatly exaggerating the impact of sanctions on its economy, Warsaw diverted attention from the shortcomings of its policies and performance. Polish officials—estimating the damage to the economy at $13 billion—have discussed presenting a reparations bill of this

magnitude to the West. The major sanctions have been bans by Western governments on debt relief talks (lifted last year) and on new credits. The refusal of Western governments to negotiate debt rescheduling, however, did not impose any economic costs since Poland behaved as if it had been relieved of any responsibility for covering its obligations to Western governments. We believe that Poland's bankruptcy has been a much stronger barrier to new credits than the sanction. [redacted]

Allocating Payment Capacity

Embassy and press reports indicate that contending factions in the Polish leadership have debated intensely the allocation of scarce foreign exchange between imports and debt service payments. In general, officials in the Ministry of Finance and Bank Handlowy (the foreign trade bank) advocate more cooperation with creditors and, implicitly, stronger adjustment measures. Officials in the Planning Commission, the Foreign Trade Ministry, and the industrial ministries generally favor imports over debt service payments and often urge a moratorium. [redacted]

The financial technocrats have prevailed enough to avoid a formal moratorium and to conclude four debt relief agreements with Western banks. The negotiators of the 1982 agreement, however, were criticized for not obtaining more favorable terms, and press [redacted] reported that top officials of the Ministry of Finance and Bank Handlowy were fired or transferred as a result. Frequent exchanges in the press have aired the debate. Planning commissioner Dlugosz argued last December that Warsaw should minimize hard currency debt payments for the next five to seven years and that adjustment measures should not hinder "the process of economic stabilization." Bank Handlowy President Glazewski responded with a strong defense of the rescheduling agreements and argued for pragmatism in future negotiations. [redacted]

Performance in 1984

The pattern established in the past three years—slow recovery of trade, difficult rescheduling negotiations, and declining credit availability—has continued in 1984. Although financial relations with government creditors may be restored, we expect no quick or major improvement in Warsaw's financial situation. [redacted] 25X1

1984 Balance-of-Payments Plan

Warsaw projects another rise in the trade surplus this year to $1.3 billion (see table 2). Exports and imports are to increase by 15 percent and 14 percent, respectively. The surplus on nontrade items will be down to 25X1 $200 million from $500 million in 1983, in part because of the need to grant credits to cover Polish exports. The Poles have issued several different projections of credit availability. The most recent assumes $770 million in new loans:

- $300 million from commercial banks, most of it resulting from the 1984 rescheduling agreement.
- $170 million in trade credits guaranteed by Western governments.
- $300 million from the Bank for International Settlements.

Based on Poland's plan, *earned* payment capacity is $1.5 billion; the *total* payment capacity is $2.3 billion. [redacted] 25X1 25X1

Results from the first part of 1984 show that Warsaw is finding it difficult to meet its relatively modest payments goals. Foreign trade in the first quarter was virtually unchanged from a year ago, and at midyear Polish officials acknowledged that the trade surplus may reach only $1.1 billion. Poland drew only $90 25X1 million in new credits through March. Although 25X1 credits under the 1984 bank agreement will boost the total late in the year, slow progress with the Paris Club will limit guaranteed credits and rule out a BIS loan. Thus, we expect that Warsaw will fall short of its targets for both earned and borrowed payment capacity and that total payment capacity will be less than $2 billion. [redacted] 25X1

We estimate that in 1984 Warsaw owes nearly $16.8 billion, $10.3 billion of which represents payments overdue from as long ago as 1981 (table 3). Debt 25X1 service due under original contracts is $5.5 billion, compared with $8 billion in 1983, because amortization of loans is declining and a greater share of interest payments is on rescheduled obligations. We estimate that nearly $1 billion will fall due under rescheduling agreements. [redacted] 25X1

Table 2
Poland:
Balance of Payments for 1984

Million US $

	Poland's Projection	CIA's Projection
Total payment capacity	**2,270**	**1,800-1,900**
Earned payment capacity	1,500	1,300
Hard currency trade	1,300	1,100
Exports	6,200	6,000
Imports	4,900	4,900
Invisibles, net (excluding interest)	500	500
Other, net	−300	−300
Borrowed payment capacity	770	500-600
Guaranteed credits	170	
Bank credits	300	
BIS loans	300	

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Table 3
Poland:
Debt Service Due in 1984

Million US $

		Comments
Total	**16,792**	
Arrears from previous years to:	10,317	
Paris Club	9,717	
On unrescheduled obligations	8,300	
On payments under 1981 agreement	417	Includes interest on interest
Banks	1,200	Covered by 1983 agreement
Other creditors	400	
Under original loans to:	5,457	
Paris Club	2,685	
Principal	1,746	
Interest	939	
Banks	939	
Principal	619	Covered by 1984 agreement
Interest	320	Payments are current
Other creditors	1,833	
Principal	1,197	
Interest	636	
Under rescheduling agreements:	916	Payments are current
1981 Paris Club agreement	200	Interest
1981 bank agreement	270	Interest
1982 bank agreement	258	Interest
1983 bank agreement	141	Interest
1984 bank agreement	47	Fee plus 5% of principal
Under new money packages from banks	102	Interest

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Agreement With Western Banks

With roughly three-fourths of Warsaw's debt to Western banks rescheduled by the end of 1983, the banks decided to include all remaining unrestructured debt in a single package (see table 4). In the first few meetings of 1984, neither side offered proposals specific enough to begin negotiations, but, in late April, the Poles and banks agreed on the following terms:

- Rescheduling of 95 percent of principal payments due from 1984 through 1987 over 10 years, including a grace period of five years.
- An interest rate of 1.75 percentage points over LIBOR on rescheduled obligations.
- Payment in 1984 of the remaining 5 percent of principal, a 1-percent fee, and interest on all of the debt to be rescheduled.
- Bank credits of $645 million this year and next; each bank is to contribute new credits equal to 4.5 percent of its exposure (about $300 million), with the remainder to come from an extension on repayment of trade credits from the 1982 agreement that come due next year.

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Table 4
Rescheduling Agreements

Agreement	Date of Agreement	Date of Signature	Obligations Covered	Amount of Debt Relief	Repayment Terms: Interest Rate	Repayment Terms: Repayment Period	Comments
Poland							
1981 Paris Club agreement	March 1981	27 April 1981	90 percent of principal and interest on medium- and long-term loans in arrears of 1 May-Dec 1981.	$2.2 billion	Varies with creditor; generally 1 percentage point above domestic government borrowing rate.	Jan 1986-89	Bilateral accord with the United States not signed because of $34 million arrears on unrescheduled payments due in 1981.
1981 bank agreement	August 1981	6 April 1982	95 percent of payments on medium- and long-term debt due 26 Mar 1981-31 Dec 1981.	$2.3 billion	LIBOR plus 1.75 percentage points	Dec 1985-88	1981 interest payments completed in March 1982.
1982 bank agreement[a]	August 1982	7 November 1982	95 percent of principal on medium- and long-term debt due in 1982.	$2.2 billion	LIBOR plus 1.75 percentage points	Sep 1986-89	Interest paid in three installments, Nov 1982, Dec 1982, and Mar 1983.
1983 bank agreement[b]	August 1983	November 1983	95 percent of principal payments on medium- and long-term debt due in 1983.	$1.2 billion	LIBOR plus 1.875 percentage points	Jan 1988-92	Principal repayment schedule is graduated: 10 percent due in 1988, increasing 5 percent annually to reach 30 percent in 1992.
1984 bank agreement[c]	April 1984	13 July 1984	95 percent of principal due 1 January 1984 to 31 December 1987 on medium- and long-term debt.	$1.6 billion	LIBOR plus 1.75 percentage points	Dec 1988-93	Unscheduled 1984 principal to be paid after signing, unrescheduled 1985-87 principal due April 1985.

[a] Separate agreement provided that 50 percent of interest payments be re-lent in the form of 6-month trade credits, rolled over for 3 years at an interest rate of 1.5 percentage points over LIBOR.
[b] Separate agreement provides for 65 percent of interest payments to be re-lent in the form of 6-month trade credits, rolled over for 5 years at an interest rate of 1.75 percentage points over LIBOR.
[c] Separate agreement calls for banks to extend 4.5 percent of their March 1981 exposure in the form of new loans, and 1 percent to be drawn in December 1985. These credits carry an interest rate of 1.625 percentage points over LIBOR through 1986 and 1.75 percentage points over LIBOR during 1987-89. Repayment is scheduled for June to November 1989. The banks also agreed to extend until 1989 the repayment of credits provided under the 1982 facility. These were originally to be repaid in 1985. The interest rate will be raised to 1.75 percentage points over LIBOR.

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Reporting from Embassy Warsaw indicates that, when some banks balked at extending new loans, the Poles threatened not to sign the agreement. In an eleventh-hour compromise, Poland agreed to sign the agreement as scheduled on 13 July, and major Western banks agreed that the pact will take effect when 97 percent of the money has been pledged. Although the banks could raise only $625 million of the promised $645 million, the rescheduling agreement went into force in late August. Embassy Warsaw reports that Polish negotiators had to overcome the objections of regime hardliners to conclude the agreement. The multiyear pact covers virtually all bank debt that has not been rescheduled and will relieve the Poles and banks of the time-consuming and contentious annual rescheduling negotiations.

Paris Club Snags

Although Western governments lifted their sanction against rescheduling in mid-1983, progress has been slow because of disputes over relatively minor issues. Warsaw has appeared inconsistent and uncertain in its approach to the Paris Club—probably reflecting internal debates over the debt issue. Warsaw is now in its third year without negotiated debt relief from the governments; arrears are more than $8 billion and climbing at the rate of more than $200 million monthly.

When it approved resumption of negotiations in July 1983, the Paris Club served notice that, at least in the early stages, Poland will have to give more than it will get. The creditors agreed that Poland must cover obligations from 1981 before further debt relief could be concluded. When the Paris Club ordered the Poles to meet these obligations by the end of 1983, Warsaw refused and informed some major creditors that none would be paid unless new credits were extended.

After the Poles failed to attend a meeting early this year, several creditors concluded that a sweetened deal was necessary to lure Warsaw to negotiate. The Paris Club adopted a German proposal for a three-year rescheduling package to replace the earlier insistence on a year-by-year approach. Warsaw would have to cover arrears, under the 1981 agreement, in three installments—20 percent "immediately," 30 percent at the time of agreement on terms of debt relief for 1982 through 1984, and the remaining 50 percent when the latter rescheduling agreement is signed. After some delay, the Poles accepted the proposal and promised the first payment—some $80 million by our estimate—by the end of May. At a meeting in mid-September, the Paris Club creditors reported that Warsaw had made, or would soon make, the required first installment and tentatively agreed to begin talks on rescheduling 1982-84 obligations in late October.[2]

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The main reason for delay in reaching agreement is that Warsaw wants new credits from the Paris Club members, as well as support for Warsaw's three-year-old application to join the IMF—requests which Western governments insist are outside the scope of the Paris Club. Creditors have little leverage. Default is not a realistic threat, and most West European governments are anxious to lift the much milder economic sanctions now in place. Although the Paris Club has made several concessions, the creditors still insist that Poland take the first step of establishing a net flow of payments.

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Sharing the Money

Warsaw has provided detailed plans for distributing its projected payment capacity among creditors. The Poles say they would pay the following this year:

- $417 million to Paris Club creditors to cover arrears under the 1981 agreement.
- More than $1.5 billion to Western banks (a) under previous rescheduling agreements, (b) in interest due in 1984 under original loan contracts, and (c) in payments under the new bank agreement.
- $829 million to socialist, Arab, and other unspecified creditors.

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According to our estimates, Warsaw not only has overstated its payment capacity by $400 to $500 million, but it will need $600 million more than the above projected amounts to meet the minimum payments due to banks and Paris Club creditors. Largely

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[2] In addition to the interest on the 1981 agreement which is due to all Paris Club creditors, Poland owed the United States $34 million in debt service excluded from the 1981 agreement. The United States withheld signature of the bilateral debt relief accord when martial law was imposed but signed the agreement early this year. For several months, Warsaw now insisted on language changes before concluding the agreement and making the payments, but, in mid-September, Warsaw paid nearly $30 million to the United States.

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because of higher interest rates, we calculate that Warsaw will have to pay banks nearly $1.5 billion to cover the types of obligations Poland has met in the previous rescheduling arrangements. This would leave only $300-400 million in payment capacity—enough to cover arrears to Paris Club creditors under the 1981 agreement, assuming that Warsaw paid nothing to creditors outside the bank group and the Paris Club. The Poles could not meet other payments amounting to $1-2 billion that the government creditors would want this year:

- For the time being, the Paris Club maintains that Warsaw should be current on the 1981 agreement through May 1984 rather than December 1983, a difference of perhaps $100 million.

- The governments may ask for more interest payments and penalties on overdue interest.

- A debt relief agreement with the Paris Club on $11.2 billion in principal and interest due in 1982-84 could require substantial downpayments. If the creditors negotiate debt relief on the same terms as in 1981—rescheduling 90 percent of both principal and interest—Poland would need to pay $1.1 billion this year. If rescheduling covered 95 percent of debt service, this would leave $560 million to be paid.

Warsaw's inability to meet the government creditors' minimum demands for money may explain the regime's stalling with the Paris Club. Governments could improve their prospects for being paid by providing new credits. The only other alternative would be if the banks, the Paris Club, and the Poles reached an agreement specifying how the creditors would share Poland's limited payment capacity.

In short, Warsaw appears likely to make little financial progress this year. A debt relief agreement with the Paris Club would cover much of Warsaw's financing requirement by covering most of the arrearages, but prospects are uncertain for reaching agreement this year—particularly on terms that creditors would accept and the Poles could afford. While optimistic Polish projections call for a financing gap of $300 million, we expect a gap of well over $1 billion even if agreement is reached with the Paris Club. Failure to reach an agreement will leave Warsaw and Western governments with the continuing problem of how to deal with arrears of some $13 billion. 25X1

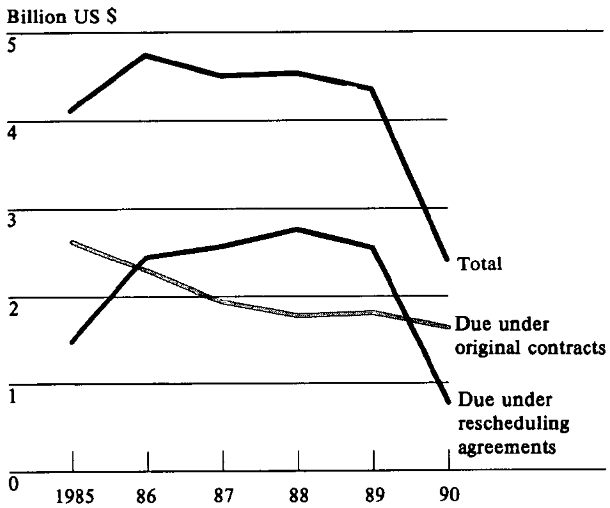
The Longer Run Outlook

Even if Warsaw and the Paris Club reach an accommodation on arrears and the Poles cover obligations due in 1984, financing requirements will be unmanageable for many years. In 1985, despite four years of debt relief, Poland will confront a formidable debt maturity structure (see figure 3 and appendix A). Not only will further reschedulings be necessary, but creditors almost certainly will have to renegotiate agreements already concluded. A robust recovery of the Polish economy over the next few years could generate earned payment capacity adequate to avoid these problems, but we consider such a recovery unlikely. An alternative would be a large inflow of credits, but this also seems unlikely and in any case would increase the debt burden and shift it ahead to the 1990s. 25X1

Continuing Large Payments Due

Obligations under rescheduling agreements already signed will, we believe, absorb most or all of Warsaw's payment capacity into the late 1980s, leaving little room for debt service under original loan contracts or 25X1
under subsequent rescheduling agreements. While amortization of original debt will continue to decline—virtually all debt to banks has been rescheduled—obligations under debt relief agreements will increase substantially when grace periods end. The debt relief provided by rescheduling agreements was inadequate to allow Warsaw to recover financially, and the Poles did not take advantage of the breathing space to implement needed adjustment measures. 25X1
Poland therefore will continue to face large financial gaps that can only be filled—if at all—by more debt relief and new credits. The need for a second round of rescheduling of the obligations originally due in the early 1980s seems inevitable in 1985 or 1986. 25X1

Figure 3
Poland: Payments Due to Creditors, 1985-90



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Necessary Conditions for a Financial Recovery

The severity of Warsaw's bankruptcy is highlighted by its inability, at least over the medium term, to pay even the interest on its debt. As long as interest is unpaid, the debt will continue to grow and Warsaw will be chasing a target that is moving away. Poland's plan to 1990 projects that debt will grow from $26.4 billion at yearend 1983 to $32.8 billion in 1990. The larger debt—representing involuntary lending [3]—will require larger interest payments and make it even more difficult to escape the debt treadmill.

We define the first stage of financial recovery as achievement of an earned payment capacity sufficient to pay interest. We judge that, before creditors will resume voluntary lending, Warsaw must demonstrate enough adjustment to balance its current account for perhaps a year or two. This is a necessary but not a sufficient condition: Warsaw still would need debt relief from obligations under original loan contracts, and it would not be able to meet repayments under rescheduling agreements now in force. Warsaw's problem in trying to run large trade surpluses is that imports have already been pared to one-half the peak level of 1980, with little or no scope for further cuts. The Poles, in fact, insist that a surge in imports is necessary to supply export industries. The regime also is reluctant to reduce supplies to a populace that has already suffered a substantial decline in living standards or to industries which are operating below capacity because of shortages of imported materials and spare parts from the West. 25X1

We estimate Warsaw's earned payment capacity through 1990 under three rates of annual increase in hard currency exports from the 1983 level: (a) 10 percent, (b) 15 percent, and (c) 20 percent. In addition, we assume:

- 10-percent annual increases in imports—less than the Poles claim they need, especially to sustain higher rates of export growth.
- $500 million annually in net earnings from services.
- Yearend-1983 debt of $28 billion. 25X1

We then match this payment capacity against interest due on Warsaw's debt. We assume an interest rate of 11.5 percent annually, which includes a spread of 1.5 percentage points over LIBOR. 25X1

If Poland is to stabilize its debt in the next several years, our analysis indicates that it must increase nominal exports 15 to 20 percent annually while holding imports to 10-percent gains. Our estimates show that if imports and exports each increase 10 percent annually, Poland's debt will swell into the next century, peaking at $57 billion in 2001. This projection points up the necessity of achieving export growth rates greater than import growth. If exports increase at a 15-percent annual pace, Poland would halt the growth of its debt at $30 billion in 1986. A 20-percent export growth rate would allow Warsaw to stabilize the debt at $29 billion in 1985 (figures 4 and 5). 25X1

[3] The involuntary lending takes the form of new debt. Unpaid interest is capitalized, that is, added to existing debt, although the creditor would not otherwise approve a loan. 25X1

Figure 4
Poland: Export and Debt Scenarios, 1984-90

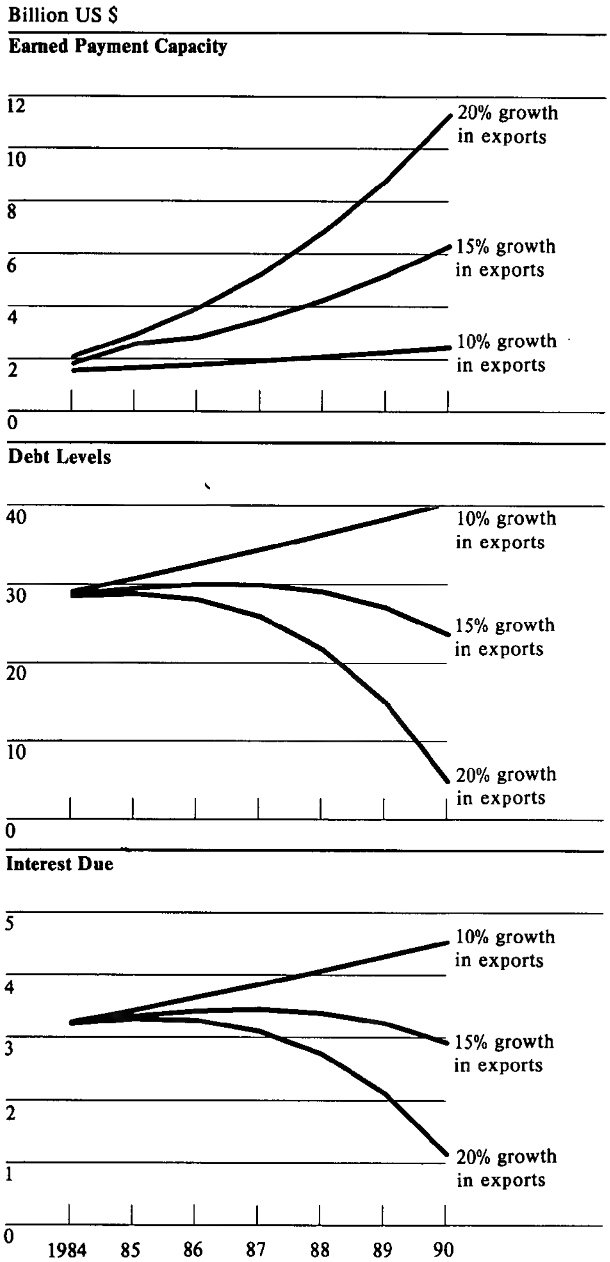

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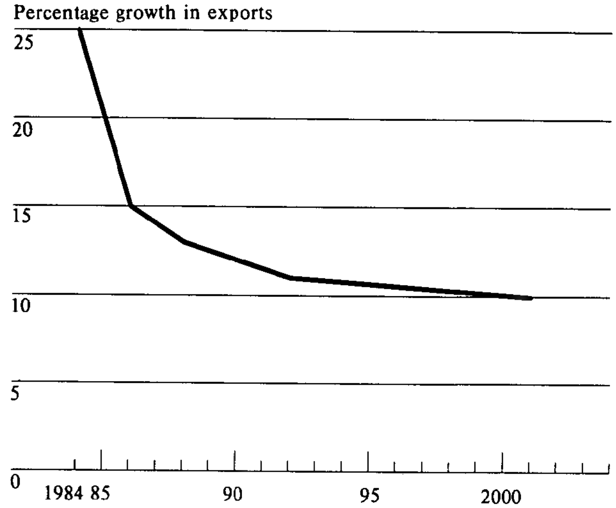
Figure 5
Polish Debt Peaks Using Different Export Growth Scenarios



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25X1

Warsaw's poor export prospects cast doubt on whether the first condition for financial recovery can be achieved. Exports in 1983 were up only 9 percent over a very poor performance in 1982, and we think that even this rate will be difficult to exceed over the medium and long term for the following reasons:

- Warsaw's depressed economy is expected to generate only slowly increasing exportable surpluses.
- The regime's interest in satisfying consumers will restrict the amounts of goods available for export, especially of meat and other food products.
- Western demand for coal, Poland's major export, is likely to remain sluggish, and coal production has peaked.
- Little progress is likely in overcoming quality and other problems that limit the appeal of manufactured goods on Western markets.
- Growth of Western markets will be slow, and export drives by other troubled debtor countries will cut into Warsaw's market shares.
- Polish plans call for substantial export increases to CEMA countries through 1990.

25X1
25X1

The alternative to seeking huge trade surpluses in the next few years is for Warsaw to persuade creditors to extend large new loans. These would boost Poland's payment capacity directly by increasing financing sources or indirectly by facilitating imports which would contribute to economic recovery and exports. The obvious problem is Warsaw's lack of creditworthiness, with creditors in agreement that prospects are poor for much improvement for many years. At best, creditors must look to the end of the 1980s for a period when commitments under current agreements decline enough to allow servicing of new credits. Prospects for further rescheduling, in fact, will push this period well into the 1990s.

Although some creditors may consider new loans to increase short-term payment capacity, they are not likely to provide much unilaterally because the money could be used to pay off other creditors. A loan package put together by all creditors would be the solution, but it would be nearly impossible to arrange. Western governments in 1981 could get no further than preliminary discussions on a package including credit guarantees and direct financial credits from Western governments, as well as a bridge loan from the Bank for International Settlements. Negotiations floundered over burden sharing among Western governments, the unsettled political situation in Poland, reluctance to commit large sums for an uncertain payoff, lack of IMF membership and the inability of creditors to impose a program of conditionality, and coordinating the package with banks and other creditors and soliciting financial commitments from them.

A few of these problems have been overcome in recent financial rescue packages for other countries, but, in general, the obstacles in Poland's case are even greater now than three years ago. Martial law cost Warsaw the Western political support that previously motivated consideration of aid. Although most West European governments are willing to ease sanctions and improve relations with Poland, there is little prospect for a quick restoration of pre-martial-law ties. Moreover, Poland's financial needs are greater now than in 1981.

Warsaw's Options

The fundamental and long-run nature of the debt problem means that financial constraints will depress Poland's economic prospects for the rest of the 1980s. Bankruptcy leaves the regime with few options, none of which are attractive. Even a generous financial package from the West would require continued austerity. Large debt service requirements probably will have a strong claim on Poland's financial resources—whether earned or borrowed—and will constrain import growth. 25X1

The Jaruzelski regime probably understands that easing of sanctions and the opening of rescheduling talks with the Paris Club are only the beginnings of a long-term process, and that a return to the large-scale Western economic support during the heyday of Solidarity is not likely. 25X1 Moreover, Jaruzelski is unlikely to allow the liberalization, reform, and independence from Moscow that the West would probably demand in return for a large aid package. 25X1

More of the Same. Poland can opt to continue to neglect adjustments necessary to overcome the debt problem while enjoying a virtual moratorium on much of its debt. Nevertheless, Warsaw can hope for little real improvement in its financial situation until it undertakes further adjustments. Poor relations with creditors will block a return to creditworthiness, and further neglect of the problem will push the debt burden into the 1990s and make it worse. Moreover, the regime can expect at best only limited improvement in political relations with the West as long as the debt issue is unresolved. 25X1

Harsh Adjustment. Alternatively, the regime could mount a major effort to tackle the debt problem by absorbing a greater adjustment burden. 25X1 At least in the short run, this would require further austerity to generate large net exports of some $3 billion annually. The regime probably believes that another drop in living standards would risk political and social upheaval. The burden of adjustment could be relieved over the longer run only by effective reform. Progress on reform has been fitful, and dividends from a more concerted effort would be a long time coming. The most critical need is to adopt measures that make export production more efficient, that provide greater incentives to exporters, and that make export production less dependent on imports from the West. 25X1 Warsaw's tentative reform program appears to have made

little progress in these areas. In fact, the financial crisis has led to greater centralization of decisionmaking on foreign trade and the allocation of scarce hard currency.

Rapprochement With the West. A third option would be a major rapprochement with the West, involving a generous rescheduling package from the Paris Club, IMF membership, and new credits. Poland would be able to clear up its arrearages and gain access to substantial amounts of financing. The declaration of amnesty for political prisoners in July and the subsequent US statement that it will consider lifting its opposition to Warsaw's application to join the IMF could be the first major steps along a course of rapprochement, but it is too early to be sure. Regime hardliners or Moscow could still derail improvement in relations, and, at best, progress is likely to be slow.

Assuming that Warsaw bids to join the IMF, it probably cannot be admitted before next year. Polish officials generally see the IMF as a source of large fresh credits, both directly from the Fund and indirectly as a result of enhanced creditworthiness. Plans recently submitted to creditors project $3 billion from the IMF in 1985-87 and $1.5 billion from the World Bank in 1986-87. The figure for IMF drawings is roughly in line with our estimates based on Warsaw's likely quota, although we do not expect substantial drawings until 1986 and even then only if Warsaw and the IMF can agree on an adjusment program. Warsaw is probably overly optimistic about the amount of money available from the World Bank. Moreover, Warsaw would have to make arrangements to eliminate arrears before being able to draw these large sums in 1986-87.

If Warsaw is to draw large IMF credits, it will also have to accept and implement a tough stabilization program. In press interviews, Polish officials have argued that the Polish economy has suffered enough in recent years and that they would resist more austerity as part of an IMF stabilization program. Warsaw also is likely to oppose some of the measures and controls that an IMF program would necessitate. For its part, the IMF has become tougher in imposing stabilization programs for troubled debtors. Its record with centrally planned economies has been mixed: Hungary's two years of membership have gone smoothly; Romania's 1981 standby arrangement was suspended because of Bucharest's debt problems and finally canceled when the Ceausescu regime failed to implement some measures demanded by the Fund. 25X1
Poland would pose a bigger challenge to the IMF. Warsaw's financial plight is more serious than either Budapest's or Bucharest's, and more than temporary financial help is needed. 25X1

Warsaw's Strategy

In the context of these options, Warsaw's financial strategy in recent years can be interpreted as shifting slowly away from a policy of minimal adjustment (1982) toward a somewhat stronger—albeit inadequate—adjustment (1983-84) with the hope that an eventual rapprochement with the West will provide enough financial assistance to gain a breathing space from the debt problem. The regime is probably overly optimistic about how soon such a rapprochement can 25X1
occur and about the West's largess. Thus, for a longer period than it seems to realize, Warsaw will have to continue to weigh the risk of further adjustment against the risk of failure to tackle the debt problem. A course of stronger adjustment directed toward restoring creditworthiness and economic recovery in the long run will result in austerity and a dissatisfied populace in the short run, while continued neglect of the debt problem will mean that the debt spiral will continue and there will be no return to creditworthiness. 25X1

We judge that the regime will gradually place more emphasis on austerity as the economy stabilizes. Any of several factors, however, could deal a setback to the adjustment trend:

- Disappointment about the outcome of Paris Club talks could lead Warsaw to perceive no benefits 25X1
  from continued efforts to deal with creditors.
- Regime hardliners could get the upper hand over the financial technocrats, resulting in policies that would shift priorities for allocating foreign exchange toward imports and away from debt servicing.
- Any increase in the regime's concern over worker dissatisfaction with austerity could also lead to an easing in adjustment policies.

- A poor crop or the threat of unrest could reverse Warsaw's recent austere import policy.
- A jump in interest rates or a Western recession would make current account balance harder to achieve. [redacted]

Implications for Western Creditors

The pivotal role of Western governments in Warsaw's economic future assures that political factors will continue to play a major role in Warsaw's financial prospects. Poland's hopes for financial recovery rest largely on extremely generous debt relief and new credits adequate to fill the large financial gaps; Western governments hold the key to advancing Warsaw's application to the IMF. The wariness with which the Paris Club has approached rescheduling suggests that repairing the damage resulting from martial law will be slow. While political motives kept the government creditors out of the rescheduling process for two years, most of the governments—especially their economic and finance ministries—have chafed at being cut off from Polish payments. For the near term at least, resumption of payments is likely to be their chief goal in dealing with Poland. [redacted]

Pressure is likely to build from Western banks and exporters for the resumption of officially backed credits, but very little probably will be available for at least a year or two. Even before martial law, Western governments were increasingly reluctant for economic reasons to extend new credits. Since then, the depth of Poland's financial problems has become more evident and other problem debtors (with whom the West has better relations) have become rivals for the credit guarantees, IMF loans, and other financial assistance that Warsaw wants. [redacted] 25X1

[redacted] banks began writing off their Polish loans as long ago as the end of 1981, with the pace of the writeoffs determined by the policies of the bank regulators and the financial conditions of individual banks. For most banks, their exposure in Poland is much less than in Latin America and is consequently less worrisome. Bankers probably regard calling default useful as a threat but dangerous and self-defeating if ever used. Default would yield the banks little in the form of seized assets and would cost them heavily in accelerated writeoffs and reduced prospects for continued payments from Poland. Banks are likely to continue to deal with Warsaw so they can obtain whatever payments are available. [redacted] 25X1 25X1

Finally, Western banks and governments face the problem of how to share Warsaw's payment capacity, which is unlikely to be enough to satisfy both for many years. The moratorium on debt to governments while making payments to banks and some other creditors violates the principle of equality of treatment of creditors. To obtain equal treatment, Paris Club creditors will have to break the well-established pattern of paying the banks first. Banks are certain to object to a reduced flow of payments and probably will want Western governments to provide new money to boost payment capacity. [redacted] 25X1

The Poles, Allied governments, and bank creditors will watch closely Washington's policy toward Poland. To a large degree, the United States holds the key to Western policy on sanctions, debt relief, and new credits, but dividends from taking the lead are uncertain at best. Poland's bankruptcy and poor prospects mean that positive steps may well involve throwing good money after bad with no guarantee of a positive political response from Warsaw, while negative steps—keeping or toughening sanctions—may lead to an open break with the Allies, ruin prospects for improvement in relations with Warsaw, and encourage hardliners in Poland who advocate a moratorium. [redacted] 25X1 25X1

25X1

Appendix A

Payments Due to Creditors

Million US $

	1985	1986	1987	1988	1989	1990
Total payments due to creditors	**4,130**	**4,757**	**4,519**	**4,548**	**4,365**	**2,413**
Original loan contracts	2,635	2,294	1,932	1,775	1,802	1,634
Paris Club	1,626	1,611	1,408	1,307	1,409	1,151
Principal	716	760	612	557	710	500
Interest	910	851	796	750	699	651
Banks	242	242	242	276	310	383
Medium- and long-term principal	0	0	0	37	77	163
Interest	242	242	242	239	233	220
Medium and long term	146	146	146	143	137	124
Short term	96	96	96	96	96	96
Other creditors	767	441	282	192	83	100
Principal	600	341	219	153	61	85
Interest	167	100	63	39	22	15
Under rescheduling agreements	1,386	2,354	2,477	2,382	1,883	780
1981 Paris Club agreement	242	747	686	626	565	
Interest on rescheduled amounts	242	197	136	76	15	
Principal repayment	0	550	550	550	550	
1981 bank agreement	493	718	651	585		
Interest on rescheduled amounts	209	150	83	17		
Principal repayment	284	568	568	568		
1982 bank agreement	260	548	799	725	651	
Interest on rescheduled amounts	260	232	167	93	19	
Principal repayment	0	316	632	632	632	
1983 bank agreement	149	149	149	204	278	315
Interest on rescheduled amounts	149	149	149	144	129	106
Principal repayments	0	0	0	60	149	209
1984 bank agreement	242	191	191	242	389	465
Interest on rescheduled amounts	191	191	191	186	165	129
Deferred principal	51					
Principal repayments	0	0	0	56	224	336
Under new money packages from banks	109	109	109	392	680	
1982 agreement	44	44	44	44	403	
Interest	44	44	44	44	29	
Principal	0	0	0	0	374	
1983 agreement	35	35	35	318		
Interest	35	35	35	18		
Principal	0	0	0	300		
1984 agreement	30	30	30	30	277	
Interest	30	30	30	30	20	
Principal	0	0	0	0	257	

25X1

Appendix B

Debt to Other Countries

More than 28 percent of Poland's debt is owed to non-Western creditors—creditors outside the Western bank group and the Paris Club. Several of Warsaw's other creditors are in serious financial straits, and Poland's nonpayment has compounded their problems. Information is sketchy on debt relief from or payments to these creditors. In general, it appears that:

- The non-Western creditors have dealt with Poland bilaterally.
- Formal debt relief agreements have not been concluded, except with Brazil in 1981 and perhaps with the USSR and other socialist countries.
- Poland has favored non-Western creditors with payments—Warsaw plans to devote more than a third of its payment capacity this year to this group—but we estimate that arrears are substantial. [redacted] 25X1

Brazil

Poland owes Brazil $1.8 billion, placing it behind only West Germany, France, and the United States in the amount of loans to Poland. In late 1981, Brasilia agreed to reschedule 90 percent of the principal payments due that year. Despite Brasilia's protests and lengthy negotiations, the unrescheduled principal and interest remain unpaid. Brazil and Poland signed a memorandum of understanding in August 1982, which called for Poland to make a $10-$20-million cash payment and to cover another $200 million by extra shipments of goods by the end of the year. The agreement soon broke down over inability to conclude trade contracts. Brazil's own financial problems have made the uncollectible Polish debt a political issue, with strong press criticism of officials responsible for the original loans and the rescheduling negotiations. Frustrated by its inability to benefit from dealing bilaterally with Warsaw, Brasilia in September 1983 decided to participate in the Paris Club with other Western creditors. [redacted] 25X1

Socialist Creditors

Another $1.8 billion is owed to socialist creditors, mainly the USSR and the two CEMA banks, the International Investment Bank, and the International Bank for Economic Cooperation. This does not include debts to Soviet- and East European–owned banks in the West, which have joined Western banks in the commercial bank negotiations. The Western press reported in April that Warsaw asked Moscow to defer until after 1990 repayments of both dollar and ruble loans which were to come due after 1985. [redacted] 25X1

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